RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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October 19, 1983 **LETTER 872**

Oct. 7 DJIA 1272.14; PTI 1774; A-D Ratio -13.79
Oct. 14 DJIA 1263.52; PTI 1769; A-D Ratio -14.35

QUESTIONS & ANSWERS: Russell, I've seldom seen a time when the outlook appeared so ripe for an economic disaster of one kind or another. People are talking about the coming clash between government and the private sector in the capital markets, they are talking about the huge expenses connected with a military build-up, they're talking about a possible major default by a foreign nation (maybe Brazil), they're talking about gathering problems in the Mid-East, they're talking about a potential slide in business next year. How do you view all this, and what can we do about it?

Answer: The best part of today's total picture is that all the disaster scenarios are receiving such wide publicity. I don't think I've ever seen a time (except in late-1957) when so many people were so worried or frightened about the future. In other words, this market has an awful lot of fear built into it. On that basis, I have to think that the market (strange as it seems, because the market is near the all-time highs) has already discounted a great many disaster scenarios.

Question: Russell, I don't get it. If this market has discounted all these fears, why is it still near the record highs?

Answer: That's a good question. And I'll answer it as simply as I know how. The market has discounted the bad news and it is staying at, or near, the highs because it is one heck of a strong market. It just doesn't want to give–no matter what the news is. Look at it this way: the market has absorbed scary news, it's absorbed the deflationary implications of the gold break, it's absorbed earlier big money supply figures, it's absorbed Lebanon, Central America, the South Korean plane incident, you name it. And still it doesn't follow the bearish script and go down. When a market won't go down in the face of bad news, it usually means that it wants to go up. And that may be where we are now.

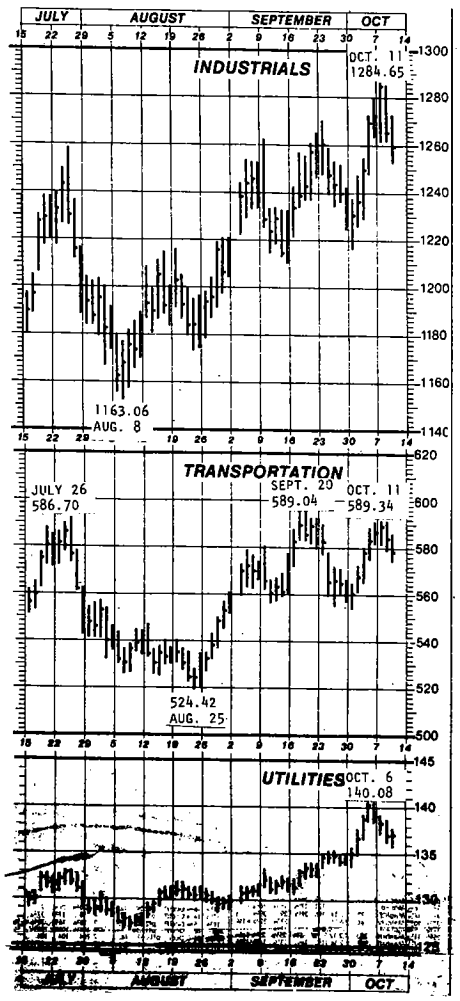
Question: Russell, you made much of the short interest in your last Letter. Why do you consider this so important?

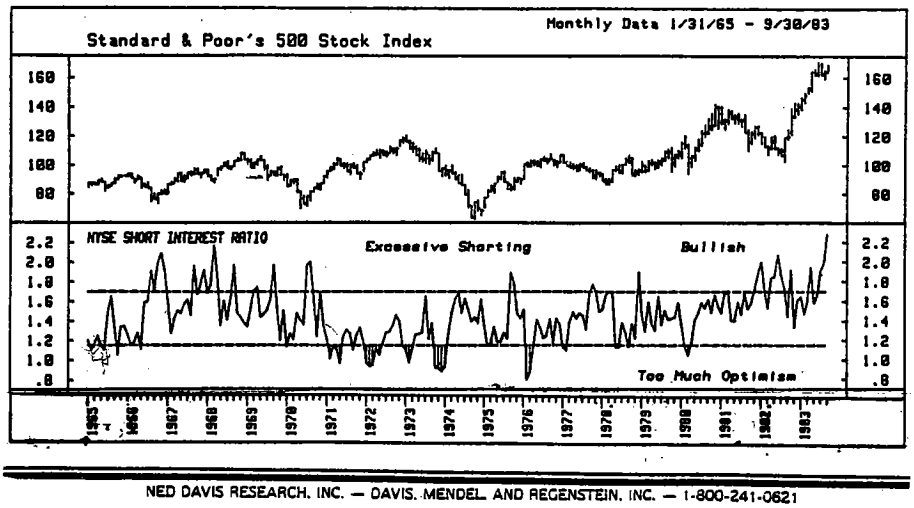
Answer: I did make quite a bullish case for the short interest figures. And I'll discuss it further now. I'm always interested when ANY indicator moves to or near an historic high–or at least moves to a level that has not been seen in years. For instance, the D-J Utility Average is now at its highest level since 1969. That's a situation worth noting, and it's a bullish situation. By the same token the NYSE short interest ratio (monthly shorts divided by average daily volume) stands at 2.28, the highest level in 25 years! The AMEX short interest ratio is at 2.18, highest level since the October massacre back in 1978.

The latest figures show that a record 168 million shares have been sold short on the NYSE. That means that on any given day when NYSE volume drops below 84 million shares (168 divided by 2 is 84), the short interest RATIO will climb above 2.00. And if, for example, volume drops to as low as 50 million shares on a given day, the S.I. ratio would climb to a whopping 3.36. You see, when traders are short they need BIG volume. But when the market declines on LOW volume (as it has been doing lately), the shorts get no encouragement. In fact they get that "old trapped feeling." (Chart page 2).

Remember, in a bull market dull spots (low volume) are usually considered "buy spots." And that is the way this bull market is working. So dullness or low average daily volume is a disaster for the short sellers, and this is exactly what the short interest ratio measures. I am including this revealing chart courtesy of Ned Davis Research, and here we see that the ratio is at its highest level since 1958 (at which time a great bull move was underway).

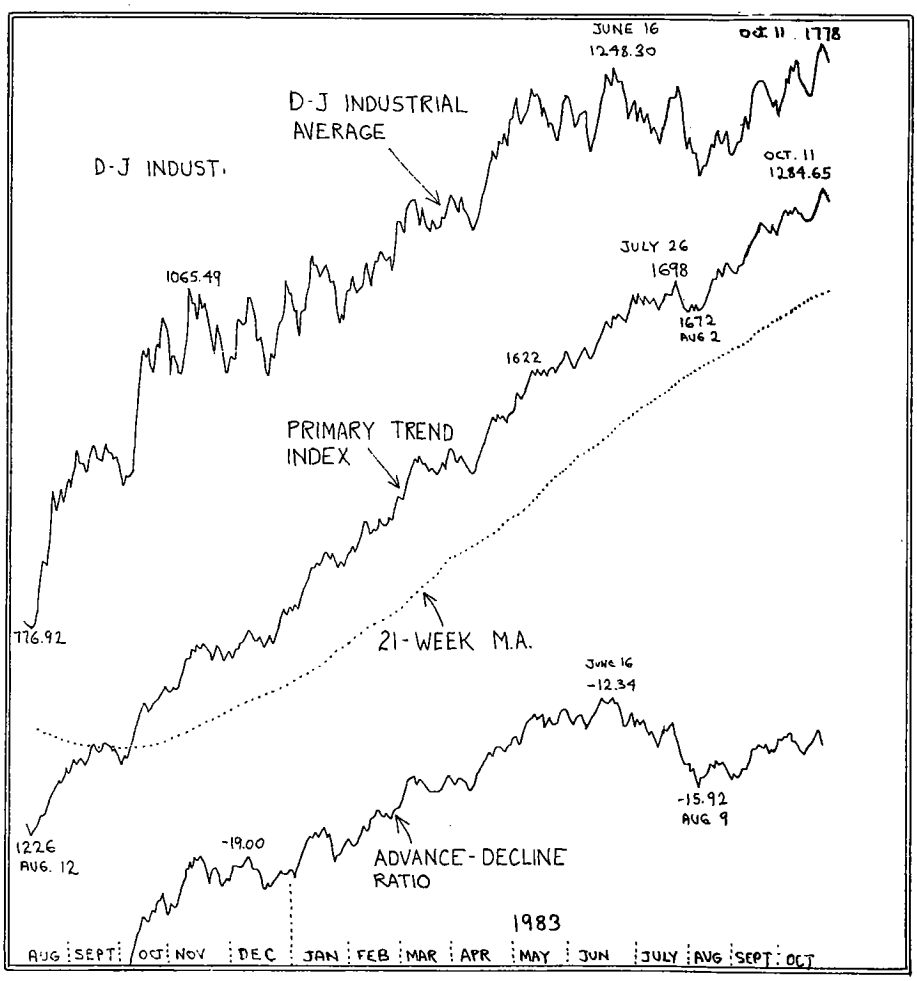
Marty Zweig (747 Third Ave., NYC 10017) keeps a combination of the two short interest ratios, the AMEX and the NYSE. States Marty, "The Average short interest (of the two exchanges) is a towering 2.31, the second best in its 24 year history. There have




Standard & Poor's 500 Stock Index
Monthly Data 1/31/65 - 9/30/83
NYSE SHORT INTEREST RATIO
Excessive Shorting
Bullish
Too Much Optimism
NED DAVIS RESEARCH, INC. — DAVIS, MENDEL AND REGENSTEIN, INC. — 1-800-241-0621

been only 13 other months since 1959 when the average S.I.R. was 1.95 or greater. Adjusting for overlapping periods, the average New York stock was 17.3% higher just six months after these bullish scores, rising in every case (100% batting average). That's an annualized gain of plus 37.2%."

So these are some of the reasons that I feel that this spectacular reading in the short interest ratios is so significant. The only more bullish manifestation would be a new October high in the total short interest in the face of a market that is backing and filling on even lower Average volume.



Question: Russell, what about a high short interest within a primary *bear* market?

Answer: Ah, now you are talking about a horse of an entirely different color, and this is something you have to be careful of. When you have a high short interest in a primary bear market that simply means that the bears (ultimately) are going to be right. They have the primary trend with them, and the market is going to bail them out. But in today's *confirmed* bull market a high short interest tells us that there is a huge bullish potential that has not been expressed. When this market breathes its last, I expect that the NYSE short interest ratio could be down to or near 1.2 or even below 1.00.

Question: What about the recent non-confirmation on the part of the Transports? On September 20 the Transportation Average closed at 590.04, less than a point below its previous record high of 590.63 (set on June 27). But the Industrial Average went on to set a record high of 1260.77 on September 26 (a record which the Transports did not confirm). Isn't this a worrisome situation?

Answer: Any non-confirmation is a worry. But in the great majority of cases, a primary penetration (i.e., a rally to new record highs) by one Average is accompanied, in due time, by a confirmation by the other Average. What was so interesting about the non-confirmation by the other Average? What was so interesting about the non-confirmation on the part of the Transports is that every technician in the nation seemed to seize on it as a reason to be bearish–at least short-term. When I first started these reports people used to ridicule me when I wrote about non-confirmations ("the Rails are a dying industry and confirmation doesn't mean a thing"). But now, during a strong primary bull market, when Transports fail by a fraction to confirm, the whole world hears about it, and the whole world worries. For that reason, I say that we must give the bull market time. In due time the Transports should confirm. I really want to give this primary bull market the benefit of the doubt.

Question: Russell, I know you've been writing about the "highest level since 1968" in the D-J Utility Average. Why is this so important?

Answer: The D-J Utility Average only came into existence in 1929. Therefore, the founders of the Dow Theory (Dow, Hamilton, Rhea) really had no history of the Utility Average and did not incorporate it in the Dow Theory. But E. George Schaefer, the great Dow Theorist of the 1940s through the '70s, did take note of the Utility Average, and he considered it very bullish for the market when Utilities moved to new highs. I concur with Schaefer, and I believe that the current series of 14-year highs in the D-J Utility Average is simply a confirmation that the primary trend of this market is bullish. And after all, that is the single most important fact to know in investing–the direction of the primary trend.

Question: What evidence do you have that a primary bull market is still in force?

Answer: This is a critical question, and (for some reason) one which few analysts are addressing today. First, let's grasp this concept. The breadth of the market (i.e., the A-D ratio) topped out on June 16. So we could say that this market has been in a corrective phase ever since–a period of over four months. But look what has happened in the past week or so. (1) The D-J Industrial Average recorded an all-time high. (2) This was confirmed on October 10 when the broad NYSE Composite Index hit a record high, as did the S & P 500. (3) The D-J Utility Average (a bellwether indicator) struck its highest level since 1968. (4) My PTI, which has been leading the way up since August, 1982, recorded another all-time high. (5) the cumulative upside/downside volume index rose to a bull market high. (6) the positive volume index hit a new high. (7) the cumulative most-active stock recorded a record high. And some analysts claim that this is a bear market? They're simply ignoring what they're seeing; they're ignoring the message of the market. If a primary bear market had started on June 16, I would expect a great amount of deterioration to have set in by now. The fact that the PTI, the D-J 65, the D-J Utility Average, the OBV and the most-active stock index all hit highs months after June 16 tells me that this is a continuing primary bull market. Major indicators and averages don't establish record highs four months after a bull market peak. I cannot over-emphasize the importance of this line of reasoning.

Question: I note that the over-the-counter market has taken a real beating over the past few months. What does this mean?

Answer: The O*T*C* market has been the big boomer ever since August, 1982. This is where the most speculation has been, and this is where the most foolishness has evolved. In many cases, worthless stocks and suspect new issues have been floated upward in the O*T*C* market. In order for the next phase of the bull market to begin, a lot of this speculative froth has to be corrected, and that's what we're seeing. So while many underpriced blue chips and investment-grade market leaders have been little affected by the correction, the junk issues and cats-and-dogs have taken it on the chin. Nothing unusual about this action; I've seen it occur dozens of times within ongoing bull markets.

Question: Russell, I note that Barron's lists the current price/earnings ratio for the Dow at 108. How can we justify record levels for the Dow with such crazy P/E ratio?

Answer: What has happened is that a few Dow stocks have shown deficits for the quarter, and this has thrown the combined Dow earnings into the cellar. But this has happened before. In fact, in 1932 when the 30 Dow stocks produced a net deficit for the Average, the P/E ratio rose to infinity. But stocks at that time were the buy of the century. So the108 P/E for the Dow today simply means that the Dow earnings are distorted (on the downside) by a few companies that have been badly hurt.

I don't know how many people realize it, but after-tax corporate profits for second quarter, 1983, were at record levels and the third quarter results should be just as good or even better. In fact, this excellent chart by Davis Research graphically (bottom of page) shows the story. Adjusted corporate profits are going through the roof!

Question: I know you have always said that news goes with the trend. So Russell, what kind of news and what kind of action do you see for the bull market in the period ahead?

Answer: The answer to that question could take up a book. But here are some ideas I have. In Letter 868 I wrote that I expected gold to break under 400. I said that the bond market would take that as a signal for "no inflation," and that the bond market would love "no inflation" and consequently, move higher. Higher bonds would produce lower bond yields, and the stock market would like that. So I saw stocks and bonds as a buy and gold as a sale.

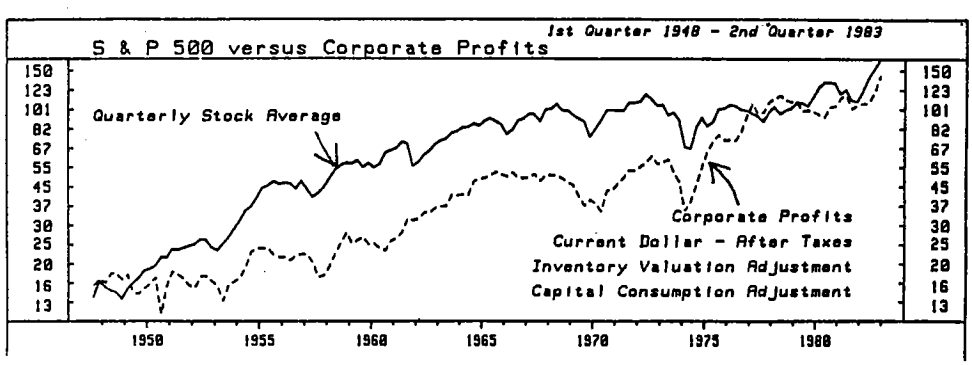
Recently, gold broke below 400, and the bond market rallied. The stock market liked the higher bond yields and spearheaded by the Utility Average the market moved up with the Dow at recorded highs. So far, so good.

My feeling from here is that this bull market is going to go higher and last longer than most people realize. I don't know if I want to place levels and dates on a prediction, but I will say that I think we will be able to *identify* the area of the ultimate top. Right now, I could guess that the Dow might hit better than 2000 by 1986, and, of course, a lot depends on whether investors remain as conservative and pessimistic (scared) as they have been so far.

For instance, I've written over the past few months that there's been a national obsession with "the coming correction." Most analysts have paid more attention to the possibility of a correction than they have to the job of becoming invested with the primary bull market. The odd lotters have been heavy sellers and the short interest has risen to a record high. The ratio of AMEX volume to NYSE volume has been low, and I would have to say that there has been a very subdued attitude towards one of the most powerful bull markets on record.

You have to remember that today there are hundreds of "technicians" scrutinizing the market, and this is a situation which has *never existed before.* So the bull market has a new job–how to keep the technicians worried and wringing their hands Remember, the bull doesn't want everyone climbing aboard, and it knows that the technicians now have a wide audience. So if the technicians can be kept on the worry side, everyone else will be kept on the worry side too. How to keep the technicians worried? Easy, numerous non-confirmations, over-speculation in some areas, mini-collapses in some groups, divergences, etc. And that is where my Primary Trend Index (PTI) comes in. The PTI measures the

(continued on Page 5)



DEFENSE SECTION

Most or all of the defense information (but not stock information) is based on an exclusive arrangement with **Mr. Melvyn Lippman of US Organization Chart Service**, La Jolla, California.

U S AND USSR: A DIFFERENCE IN RESEARCH AND DEVELOPMENT CONCEPTS.

Question: Mel, I know that US technology is outstanding. We've always been a leader in technological innovations. In view of that, how can the Soviet military be equal or even ahead of us? What have they been doing that we haven't?

Answer: Since World War II, the US has exploited superior military technology to offset Soviet superiority in masses of men and equipment. The US no longer holds the qualitative advantage it once had. Continuing to build their lead in quantity, the Soviets have closed the quality gap in key areas of military technology and are striving to close it in many others. The trend of diminishing US technological superiority has become a matter of major concern.

Comparisons of US and Soviet expenditures for research, development, test and evaluation (RDT&E) show that the USSR has *consistently outspent the US* over the past ten years. Whereas the US RDT&E expenditures have remained relatively constant over the past decade, until fiscal year 1983 and 1984, the Soviets have increased their expenditures each year and are projected to have outspent the US by about $20 billion during the past decade.

Committed for years to closing the technological gap, the Soviets are now reaping the fruits of their efforts. Massive investments in military - related science and technology have resulted in gradual improvement in the Soviet strategic position from one of clear inferiority *to one of at least essential equivalence.* Furthermore, intense modernization efforts have increased Soviet capabilities in almost every category of general purpose forces.

US and Soviet weapon development programs differ widely. The Soviet process operates within a centrally managed economy and therefore experiences fewer checks and balances and more predictable budgets. In contrast, the US R&D process is less centralized and more subject to multiple reviews and fluctuating budgets.

U.S. emphasis on rapid technological advances, leading at times to revolutionary breakthroughs - historically has yielded combat systems superior to those of the Soviet Union. Yet paradoxically, this emphasis has in many cases impeded the development and acquisition of new US systems. As decisions to produce and deploy a new system are approached, new technological choices invariably appear on the horizon. In many cases, the US response has been to defer production decisions, thus foregoing an available technological advantage for a greater one in the future. Partly as a result of this tendency, the US is not now modernizing systems with the regularity needed to maintain a qualitative advantage.

Stressing incremental advances rather than quantum leaps in technology, the Soviets have consistently fielded *more weapon systems* than the United States. The effect has been to concede the present advantage and momentum to the Soviet Union.

Soviet R&D has produced a *steady progression of new conventional weapons,* with each model displaying modest improvements over the previous one. For example, the Soviet MiG 21 named Fishbed by NATO, is the most widely deployed fighter interceptor in the world and there are some 20 different versions or up-dates! Soviet aviation practices require each succeeding version of an aircraft which is deployed operationally to have some improvement incorporated into it to enhance its performance–new avionics, increased engine power, new weapon system, airframe modifications until these modifications evolve into a new generation fighter interceptor such as the MiG 23 Flogger.

In short, Soviet military R&D is marked by *continuous expansion* and an *improving technology base.* New Soviet systems are the clearest evidence of this fact, but the inevitable time lag in translating productive R&D into operational systems has masked to some extent the full potential impact of the concerted Soviet effort.

The full effects of the Soviet military R&D investment of the past decade will certainly be felt in the period ahead by the US and her allies. The fact is that by any standards, the Soviet military R&D achievements are impressive. We will have to keep the Russian military capabilities very well in mind in coming years–for the Russian military could prove to be even more impressive–and surprising–as we enter the mid 1980's.

The correction in the technology sector has hit our profits in the defense section (a profit that was 41% earlier in the year).

		Our Buy Price	Current Price	
NYSE	Harris Corp. (HRS)	49½	37 5/8	Defense stock average based on 1 share of each this week is 360
NYSE	LFE (LFE)	11 7/8	13 7/8	
NYSE	Planning Research (PLN)	14 3/8	15 5/8	
NYSE	Scientific Atlantic (SFA)	19	16 1/4	
NYSE	Tracor (TRR) (25% stock div.)	28 3/4	34 3/4	
NYSE	Electronic Assoc. (EA)	13	6 3/4	
NYSE	Varo (VRO)	19	17 3/8	
NYSE	Bolt Beranek (BBN) (50% stock)	37	81 3/8	
NYSE	BDM (BDM) (100 stock div.)	43½	88	
NYSE	Dynalectron (DYN)	12 3/4	13	% Increase is: 26%
AMEX	Moog B (MOGB)	15½	18 1/8	
AMEX	Systems Planning (SPZ)	7	9 1/4	
AMEX	American Science (ASE)	10½	7 7/8	
	Original purchase price 278			

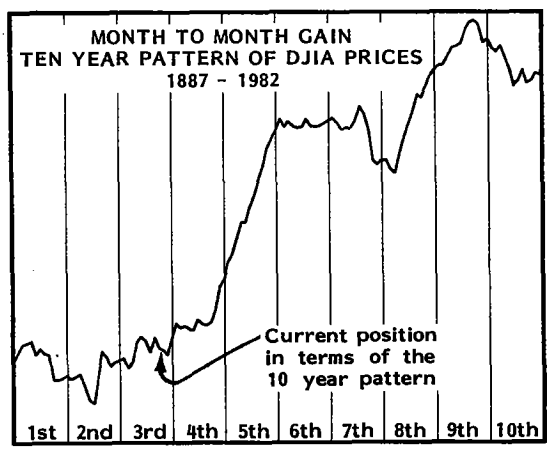
(continued from Page 3)

weight of evidence in the technical picture, and the weight has definitely been to the upside. The rallies in the market have been broad while the declines have been very selective–technically speaking. And that is why the PTI has been strong enough to hold well above its rising 21-week moving average ever since August, 1982.

There is another phenomenon which is worth noting at this time. And that is the historical or cyclical influence. The well-known four year cycle began in August, 1982 and the excellent publication, Growth Fund Guide, has some interesting things to say about that. They write, *"In recent years the NYSE four year cycle has averaged almost 50 months in length. An average move now would call for the next four year cycle low in about October, 1986. The rising portion of the cycle has averaged 35.6 months and an average move would call for a peak in the current long-term trend in about mid-1985."*

Growth Fund Guide then talks about the "decennial pattern" and they include this chart showing the average action of the Dow through 9 cycles of the decennial pattern. Interestingly, the strongest year in the decennial pattern is the year ending in 5. There have been 8 up-years in the years ending in 5 (1915, 1925, 1935, etc.) but never a down year. No other years in the decennial cycle show up that strong. (Growth Fund Guide, Box 6600, Rapid City, SD 57709).

So the cyclical influence in the stock market could easily take the bull market into 1985, and if speculation remains subdued the bull market could extend to 1986 or even further.



Question: Russell, I note that many of the leading economists are continuing to warn about inflation. They say that last year's explosion in the money supply is guaranteed to produce inflation in the months ahead. What do you think?

Answer: First of all, nothing is for sure when it comes to either the stock market or economics, so I take all forecasts with a grain of salt. But certain things are happening, and they are not predictions–they are reality. One thing that has occurred is shown on the accompanying chart (at right) (chart courtesy of John Carder of Colorado). Here we see a ratio of two items that are both extremely sensitive to inflation or deflation. Gold tends to rise during inflation while bonds tend to slide during inflation. The ratio of the two is therefore a super-sensitive indicator of inflation or deflation.

Note that from April 1981 to February 1982 the declining tops in the ratio favored deflation. From February 1982 to September 1982 the ratio traced out a large triangle so that the inflation/deflation forces could be considered in equilibrium. Then a few weeks ago the ratio plunged below the rising trendline (as gold sank and the bonds rallied). The implications are clear: the markets see NO inflation over the foreseeable future. The ratio is now pointing to either disinflation or actual deflation. That's the voice of the market, and the economists are welcome to argue with it.

INVESTMENT POSITION: As this is written the PTI is still in a definite bull trend, and the bull remains in the box (the bull signifies a primary bull market). The defense list has been hit by the general correction in almost all the technology stocks–but remember, it's still a bull market. Hold your no-load funds for ultimate higher prices. This market is digesting all sorts of worries and calamity scenarios–but it's acting well in the face of them. The bond market continues to build what appears to me to be a longer-term base. Stick to Treasury bonds or bonds in the AAA class.

NOTES & QUOTES: According to the latest statistics from the Rockefeller Foundation the world is now spending the astounding figure of $660 billion on armaments each year. Furthermore, the US and Russia (with 11% of the world's population) now account for over half of the world military budget. The US cost for defense is now $885 per capita compared with $75 just before World War 11. To give some idea of costs involved, the cost of a single nuclear submarine equals the annual education budget of 28 developing countries with a school-age combined population of 160 million. And it isn't getting any better!

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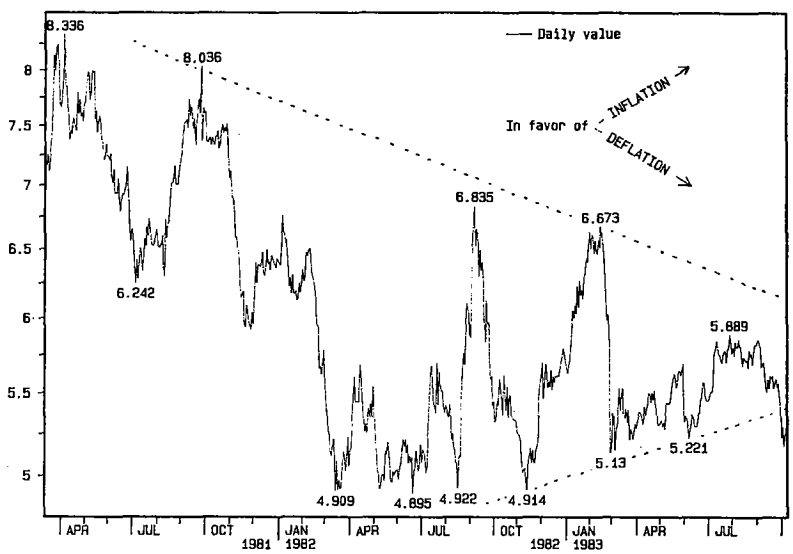


LONDON GOLD (PM FIX) / US TREASURY BOND 8s 1996-01 Aug

To a pleasanter subject, what has Nebraska wrought? The 1983 Nebraska Cornhuskers are considered by many to be the greatest college football team of all time. So far, the team has crushed its opponents (in five games) by an average margin of 46.6 points per game! Furthermore, the Cornhusters have three potential Heisman trophy winners on its squad. John Riggins of the national champion Washington Redskins pro team recently stated, "There are no great football teams anymore–except maybe Nebraska."

* *

It's hard to read the newspapers today and remain optimistic about Soviet intentions. I honestly continue to search for hints or indications that the Russians want to disarm with us. I read the speeches of Soviet leaders with interest and with hopes. But it's a case of "what you see is what you get." Here are a few news squibs from the October 5 newspapers. The story is always the same. The Russians disparage US peace attempts. And they continue to do exactly what tney want–a policy of expansion and intimidation.

By DON SHANNON,
Times Staff Writer

UNITED NATIONS—Virtually ignoring President Reagan's appeal for negotiation of U.S.-Soviet differences, the Soviet Union's U.N. ambassador Tuesday delivered a hard-line speech bristling with anti-American invective.

Soviet Ambassador Oleg A. Troyanovsky's statement to the U.N. General Assembly referred only indirectly to Reagan's offer last week of new U.S. flexibility in the negotiations on intermediate-range missiles in Europe, citing Soviet President Yuri V. Andropov's rejection of the idea as a ruse.

Reagan complained the Soviets are "stonewalling" on arms control. He said the USA has had to "push, pull, probe and prod" them to no avail.

The president made a second appeal for Soviet flexibility in separate talks on intermediate-range missiles. He said he is willing to forego the controversial deployment of Pershing 2 missiles in Europe this year if the Soviets talk realistically.

By WILLIAM E. FARRELL
Special to The New York Times

WASHINGTON, Oct. 4 — Jeane J. Kirkpatrick told a gathering of conservatives today that an enlightened United States foreign policy was one that recognized the scope of the challenge posed by the Soviet Union as well as Moscow's willingness to use whatever means it could to establish "a vast empire."

She used the occasion to present a review of the Reagan Administration's foreign policy and to criticize the Soviet Union for having "established in the contemporary world a vast empire" by manipulating weak governments and by sanctioning "the use of violence."

The Soviet Union's tactics involved subversion, terrorism and the use of surrogates, Mrs. Kirkpatrick said, and they were "increasingly sophisticated" and "extraordinarily successful."

More than 7,000 Soviet soldiers have been sent to Syria this year, and the Russians have supplied Syria with $2.5 billion in military equipment, Administration officials said. This equipment, including advanced MIG-23 and MIG-25 fighter planes, up-to-date M-72 tanks and SA-5 antiaircraft missiles never before deployed outside the Soviet Union, goes well beyond what Syria possessed before suffering heavy losses to Israel in Lebanon in 1982. The SS-21 missile, an improved version of the less accurate Frog missile, has also never been assigned outside of Europe.

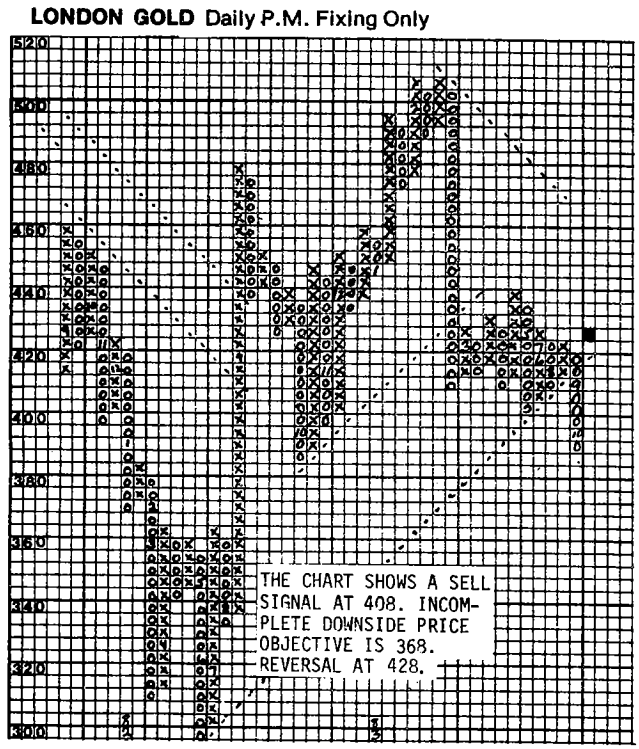
LATE NOTE: The PTI closed the week ending October 14 at 1769, only 9 points below its September 27 record high of 1978. The PTI performance can only be construed as bullish.

GOLD: There are two ways of looking at gold. One is that "this is the only real money, buddy, and when the whole world hits the fan, gold is all we've got!" That's the emotional approach, and those that think this way will hold gold come hell or high water. They'll ride gold up to 850 and watch it as it breaks 400 on the downside. They'll never sell gold, because gold is a basic part of their core assets. They view gold the way they view their house. They don't quote their house every day, and they don't quote gold every day. They just want to own it.

The other approach to gold is that it's money, real money, yes, but it's also very liquid and can be traded. And it can be a profitable investment over a major swing. But these people feel that there are long periods when they don 't need or want gold,and at such times they step out of it and into bonds or stocks.

I happen to be about 25% the first kind of person and about 75% the second. So I still have a small hoard of gold coins that I'll never sell, but the very largest part of my earlier (pre-1981) gold collection has been sold.

As you can see on the accompanying point & figure chart, gold recently gave a very important sell signal. Not only did the most recent formation break down, but the plunge took gold below its longer term rising trendline. Now there isn't a man or an institution on the face of this earth that knows whether the break below 400 is the beginning of a major new decline–or whether it marks the end of the drop from the 1983 high of 508. Fortunately, my subscribers and I don't have to make any decisions here. If gold goes down, it's going down without us because we don't own any gold here. And if gold has hit bottom and is now in the process of reversing, we've got time. Because we are not going "bottom fishing" and as far as I'm concerned, the first real sign of a reversal will be spot gold climbing to 428–where I've filled in a box in solid black. Until 428 then, let's sit tight. I love gold. I love making money. But there's nothing I can do with the yellow metal now. The market has confirmed that gold is in a bear market–until proved differently. (chart courtesy of Chartcraft, Larchmont, NY)



NEXT MAILING: Nov. 2